Oklahoma Appeals Court - Capital gains deduction provision is unconstitutional

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In brief

In an unpublished opinion, the Oklahoma Court of Appeals held that the Oklahoma capital gains deduction is facially discriminatory and unconstitutional in violation of the Commerce Clause of the US Constitution. The capital gains deduction is generally available when certain property is held for at least three years by an Oklahoma company or held for at least five years by a non-Oklahoma company. While the court did not provide a remedy to cure the constitutional defect, similarly situated taxpayers should consider filing protective refund claims. [*CDR Systems Corporation v. Oklahoma Tax Commission,* Okla. Ct. of App., Case No. 109,886, (1/17/13)]

In detail

CDR Systems Corporation was incorporated in California and had manufacturing facilities in Oklahoma. In 2008, CDR entered into a stock purchase agreement with Hubbell Lenoir City, Inc., whereby CDR sold all of its assets to Hubbell. Hubbell elected to treat the stock sale as an asset sale for federal purposes. CDR had owned the assets it transferred to Hubbell for more than three years before the sale.

CDR amended its 2008 Oklahoma Small Business Corporation Income Tax Return to claim a capital gains deduction for the amount it received from the sale of its assets to Hubbell. The deduction was denied by the Oklahoma Tax Commission. CDR protested the denial on the grounds that the Oklahoma capital gains deduction unconstitutionally discriminates on its face against out-of-state taxpayers.

Capital gains deduction provision discriminates against interstate commerce

In general, Oklahoma law provides a capital gains deduction on gains that result from:

- the sale of Oklahoma real or tangible personal property, directly or indirectly owned by a corporation, that was held for at least *five years* prior to its sale
- the sale of stock of an *Oklahoma company*, directly or indirectly owned by a corporation, that was held for at least *three years* prior to its sale
- the sale of Oklahoma real, tangible, or intangible property as part of the sale of all (or substantially all) of the assets of an *Oklahoma company*, that was held for at least *three years* prior to its sale.

An 'Oklahoma company' is defined as an entity whose primary headquarters has been located in Oklahoma for at least three years prior to the sale from which the capital gains arise.

The court found that the capital gains deduction was 'facially discriminatory' under the Commerce Clause of the US Constitution because it afforded Oklahoma companies different treatment than out-of-state companies for similar taxable events. Namely, a non-Oklahoma company receives the benefit of a capital gains deduction by holding certain property for at least five years, while an Oklahoma company receives the same benefit by holding certain property for at least three years.

The takeaway

The court failed to articulate a remedy to cure the capital gains deduction constitutional defect. Will out-of-state headquartered taxpayers be allowed the deduction when qualified property is held for only three years? Will the state fashion some other remedy? Similarly situated taxpayers should consider filing protective refund claims pending the determination of how Oklahoma will implement the *CDR* decision.

Let's talk

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